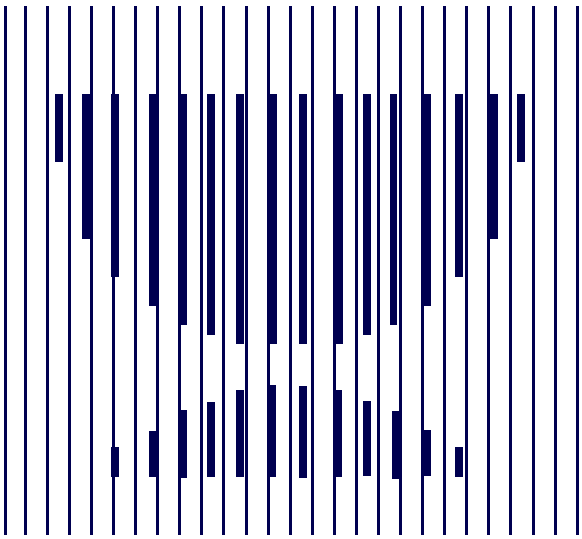
CBO MEMORANDUM

A QUALITATIVE ANALYSIS OF THE HERITAGE FOUNDATION AND PAULY GROUP PROPOSALS TO RESTRUCTURE THE HEALTH INSURANCE SYSTEM

April 1994



CONGRESSIONAL BUDGET OFFICE

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SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Illustrative numbers presented in this memorandum have been rounded for ease of exposition.

This Congressional Budget Office (CBO) memorandum was prepared in response to requests from Senator Pete V. Domenici, the Ranking Minority Member of the Senate Committee on the Budget, and Senator J. James Exon, also a member of that committee. It describes and analyzes two proposals to restructure the health insurance system. The Heritage Foundation made one; Mark Pauly, Patricia Danzon, Paul Feldstein, and John Hoff made the other. The memorandum does not estimate the costs of either proposal.

The memorandum was prepared by Kevin Quinn of CBO's Health and Human Resources Division, under the direction of Nancy Gordon and Linda Bilheimer. Within CBO, valuable comments were provided by B.K. Atrostic, Leonard Burman, Sandra Christensen, Robert Dennis, Harriet Komisar, Rosemary Marcuss, Murray Ross, and Roberton Williams. Carol Frost undertook the programming for the numerical illustrations shown in Appendix B. The Actuarial Research Corporation provided the premium estimates used in the memorandum. Outside CBO, valuable comments were made by Stuart Butler, Patricia Danzon, Allen Feezor, Edmund Haislmaier, James Mays, Mark Pauly, and Katherine Swartz.

Sherwood Kohn edited the manuscript. Ronald Moore prepared the final version, and Christian Spoor proofread it. Questions about the analysis may be directed to Linda Bilheimer at (202) 226-2673.

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CHAPTER I

SUMMARY AND INTRODUCTION

This memorandum is a qualitative analysis of two proposals that would require everyone in the United States to obtain health insurance, restructure the incentives inherent in the tax system, and set national standards for the pricing and marketing of health insurance. One proposal has been made by the Heritage Foundation; its chief authors are Stuart Butler and Edmund Haislmaier. The other proposal has been made by a group associated with the American Enterprise Institute; it is composed of Mark Pauly, Patricia Danzon, Paul Feldstein, and John Hoff. For the sake of brevity, this group is referred to here as the Pauly group. Adoption of either proposal would cause profound change to the nation's health sector, while maintaining the sale of insurance and the delivery of health care as private-sector activities.

The memorandum is not a Congressional Budget Office (CBO) cost estimate of either proposal, nor does it consider how aspects of the proposals might be treated in the federal budget. The calculations presented here are intended only to illustrate how the proposals might operate.

THE HERITAGE PROPOSAL

Although the Heritage Foundation first presented its proposal in 1989, it substantially revised it in the latter part of 1993. In November 1993, legislation resembling the revised Heritage Consumer Choice Health Plan, but different in several significant ways, was introduced by Senator Don Nickles as S. 1743 and by Congressman Cliff Stearns as H.R. 3698. It should be emphasized that this memorandum is an analysis, not of these bills, but of the revised Heritage proposal, which is summarized in Appendix A. That proposal calls for full implementation on January 1, 1997.

In order to guarantee universal health care coverage, everyone would have to obtain insurance, either through a government program or from a private insurer, on their own or through a family member. The states would be charged with enforcing the mandate and would have to arrange coverage for people who did not do so themselves. The minimum insurance would cover "catastrophic" health care expenses--that is, those exceeding $1,000 a

year for an individual or $2,000 a year for a family. (Those amounts would be adjusted for inflation after 1997.)

To help make the coverage affordable for people who did not qualify for Medicare or other government programs, the proposal would establish a new, refundable tax credit that would depend on a family's health expenses as a percentage of its income. The credit would equal 25 percent of that portion of health expenses that were less than 10 percent of adjusted gross income (AGI), plus 50 percent of that portion of expenses between 10 percent and 20 percent of AGI, plus 75 percent of that portion of expenses that exceeded 20 percent of AGI. "Health expenses" would be made up of premiums for the required coverage, premiums for any supplementary insurance plans, and out-of-pocket spending on a broad range of health services. A new federal/state program, designed by each state, would assist people with family income under 150 percent of the poverty threshold whose health expenses exceeded 5 percent of AGI even after the tax credit was taken into account.

The three tax provisions that now subsidize health expenses would be repealed. The most important is the exclusion from employees' taxable income of health insurance premiums paid by an employer. Furthermore, taxpayers could no longer deduct health expenses that exceeded 7.5 percent of AGI, and employees covered by certain types of flexible benefit plans could no longer use pretax income to pay premiums and out-of-pocket expenses.

The change in subsidies would have important consequences for almost everyone who is not covered by a government health program. Current law offers the largest tax subsidy to people whose employers pay their premiums as part of their compensation, and this subsidy is greatest for employees who have generous insurance coverage and high marginal tax rates. Out-of-pocket spending is now subsidized only for employees enrolled in certain types of flexible benefit plans and for people who itemize deductions and whose health expenses exceed 7.5 percent of AGI. People who buy insurance on their own do so with after-tax income and are eligible for a subsidy only if their health expenses exceed 7.5 percent of AGI.

By contrast, the proposed tax credit would be unaffected by employment status, would treat premiums and out-of-pocket spending similarly, and would offer the greatest subsidy to those people whose health expenses were high in relation to their incomes. The proposed credit would also encourage spending on health compared with spending on other items in the household budget, since all privately insured families would receive a subsidy equal to at least 25 percent of their health expenses.

The proposal calls for other changes that would contribute to a restructuring of the employment-based health insurance system that is in place today. The federal government would take over much of the regulation of health insurance from the states, requiring that insurers unconditionally accept all applicants and that premiums vary only with the age, sex, and geographic residence of the policyholder. Group-purchasing discounts would be allowed; how these discounts would be regulated would determine whether premium variability would be as limited in practice as the proposal advocates. If such discounts were tightly regulated, insurers would have less ability than they do now to select the pool of people they would cover and would have greater incentives to control the price and volume of the health care services that their policyholders used.

Employers would not have to offer health insurance benefits to their workers, but those that currently offer such benefits would have to pay out the value in cash to their employees, who could buy coverage anywhere they pleased. As a result, health insurance would become more of an individual purchase than is the case today, with consequent increases in marketing costs borne by insurers. Employers that self-insured would become subject to the regulations facing insurers in general, including the requirement to accept any applicant, not just those connected with their work force. They would therefore be much less likely to operate plans themselves.

The impacts on families would depend on the interplay of many variables, some of which are exceptionally difficult to predict. In general, lower-income people would benefit more than those with higher incomes, and people with higher health expenses would benefit more than those with lower expenses. People who now have employment-based insurance would see an increase in the proportion of their total compensation that was subject to taxation, but would benefit from the tax credit. The net effect would depend on their circumstances. People who now buy insurance on their own would become better off financially, since they would receive the tax credit without an offsetting increase in their payroll and income tax liabilities. The uninsured would have to buy insurance, the cost of which would be only partly offset by the subsidy and could be a considerable burden. People covered by Medicare, Medicaid, the military health services system, and similar programs would not be directly affected; if they became ineligible for government coverage, they would receive the subsidy and face the mandate in the same way as everyone else.

The chief costs to the federal government of carrying out the proposal would result from the proposed tax credit and the proposed federal/state program for people with low incomes. The cost of the credit would depend on spending in a health sector quite different from what we see today, making

estimation very difficult. The new federal expenditures would be offset by revenue from eliminating the current subsidies as well as by changes in the Medicare and Medicaid programs that would reduce federal spending below what it otherwise would have been. The most notable changes would be imposition of a cap on part of the federal contribution to Medicaid and the proposed elimination of payments by Medicaid and Medicare to so-called disproportionate share hospitals. This memorandum contains no estimate of whether carrying out the proposal would, on balance, increase or decrease the federal deficit.

THE PAULY GROUP PROPOSAL

The Pauly group places more emphasis than does the Heritage proposal on maintaining today's employment-based insurance system and on removing taxes from the list of considerations that people weigh in making decisions.[1] The group's proposal also is not as completely specified, which makes some of its effects unclear. The authors say the proposal could be carried out all at once or in stages. For example, a ceiling on employer-paid premiums excluded from employees' taxable income could be progressively lowered, with revenues from the cap devoted to gradually expanding the proposed new subsidy.

Again, universal health care coverage would be achieved by requiring that each individual obtain insurance. The Medicaid program would no longer cover acute care for people under 65 years old, so beneficiaries would have to obtain subsidized private insurance. The mandate would be enforced through the taxation and welfare systems; the proposal does not describe the responsibilities of the various levels of government more precisely. The Congress would determine the minimum plan necessary to satisfy the mandate; at one point, the authors suggest coverage similar to that now offered by a health maintenance organization.

The three tax subsidies for health spending under current law would be repealed, to be replaced with a refundable tax credit that would depend on a family's expected health expenses, not its actual expenses as under the Heritage proposal. For a family of average risk status whose income was below the poverty threshold (estimated to be about $11,800 for a family of

1. Principal expositions, all written by Mark Pauly, Patricia Danzon, Paul Feldstein, and John Hoff, are *Responsible National Health Insurance* (Washington, D.C.: AEI Press, 1992); "A Plan for 'Responsible National Health Insurance'," *Health Affairs*, vol. 10, no. 1 (Spring 1991), pp. 5-25; and "How We Can Get Responsible National Health Insurance," *The American Enterprise* (July/August 1992), pp. 61-69.

three in 1994), the credit would equal 100 percent of the premium for the minimum plan. The value of the credit would decline as income rose, to reach zero at a point between three and five times the poverty threshold (or between about $35,500 and $59,100 for a family of three in 1994). Families whose risk status was above or below the average would receive a credit adjusted for factors such as age, sex, geographic residence, and health status. The adjustment process is otherwise unspecified; questions about the design of such a process raise perhaps the most significant issues about the proposal.

Since the credit would be unaffected by how much a family actually spent on health, families would have stronger incentives than under the Heritage proposal to economize in purchasing insurance and paying out of pocket for health care. In sharp contrast to the situation today, the amount of money a family spent on health and the way in which it spent it would have no effect on its tax liabilities.

In its proposed changes to the insurance market, the Pauly group takes a position almost opposite to that of the Heritage Foundation. The Pauly group would allow insurers to charge any premiums they wished to new policyholders, a practice known as pure risk rating. Insurers would face limits, however, in the premium increases they could charge people renewing their policies. To allow insurers this scope, the federal government would have to preempt the growing number of state laws that limit the variation in premiums charged to individuals and small groups. Under such a system, insurers would have little incentive to seek out low-risk applicants and avoid high-risk applicants, since everyone could be charged premiums that reflected their risk levels. Insurers would presumably use risk rating to a greater extent than they do now, since any that did not do so could be at a competitive disadvantage. This matching of premiums to risk levels could require a substantial expenditure of resources, however. If pure risk rating proved to be impractical, the proposal says that limits on premiums could be instituted.

Employers would not be required to pay their employees' health insurance premiums, but those that did so would have to report the value to the Internal Revenue Service. In contrast to the Heritage proposal, employers would not have to "cash out" health insurance benefits to their workers, and if they chose to offer insurance they could require all employees to be insured through the workplace. As a result, insurers would probably continue to regard employment-based groups as relatively predictable portfolios of risk, reducing the need to expend resources on risk assessment. Employers would continue to be able to restrict coverage to their employees, spouses, and dependents.

The proposal's net impacts on families whose risk status differs from the average cannot be analyzed. How much the family would have to pay for insurance would depend on whether it was part of a group and how the insurer geared premiums to risk levels. In theory, the tax credit would vary among families to parallel these differing premiums, but the unspecified nature of the tax credit makes it impossible to draw inferences about the operation of the subsidies.

Since people above certain income levels would receive no tax credit, the inverse relationship between income and the subsidy would be stronger than under the Heritage proposal, holding other factors constant. The proposal would also unambiguously benefit people who now buy insurance on their own, while requiring uninsured people above the poverty threshold to spend more on insurance than they would receive from the tax credit. The impacts on people who now have employment-based insurance would depend on their individual circumstances.

The chief cost to the federal government would be the proposed tax credit; the magnitude would depend on premium levels set by specific types of insurers and on the process for adjusting the tax credit for risk status. In total or in part, this cost would be offset by increased tax revenue from the elimination of existing subsidies.